UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

JEROME SAPIRO, JR. and CORNELIA B. SAPIRO,

Plaintiffs,

v.

ENCOMPASS INSURANCE; SAFECO INSURANCE COMPANY OF AMERICA; and DOES 1-10, inclusive,

Defendants.
_____/

No. C 03-4587 MHP

MEMORANDUM AND ORDER
Motion to Dismiss

On July 31, 2003, Jerome Sapiro, Jr. and Cornelia B. Sapiro ("plaintiffs") filed a complaint against Encompass Insurance ("Encompass") and Safeco Insurance Company of America ("Safeco") alleging breach of contract, bad faith, and fraud causes of action against both defendants. After removal of the action, defendants moved to dismiss plaintiffs' first amended complaint, and the court granted defendants' motion on April 30, 2004. Now before the court is defendants' motion pursuant to Federal Rule of Civil Procedure 12(b)(6) to dismiss plaintiffs' second amended complaint. Having considered the parties' arguments fully and for the reasons set forth below, the court rules as follows.

BACKGROUND

Plaintiffs are owners and occupants of the residence located at 30 Balceta Avenue, San Francisco, California. Pls.' Second Amended Complaint ("SAC") ¶ 1. Defendant Safeco has provided plaintiffs with "all risks" insurance for their home from 1993 to the present date. Id. ¶ 4. Defendant Encompass' predecessor-in-interest, Continental Insurance Co., provided plaintiffs with homeowners insurance during the period from July 1, 1979 to June 1, 1982. Id. ¶ 3.

In 1980, plaintiffs hired a contractor to build a substantial addition to their home. Id. ¶ 5. Work performed by the contractor included the construction of a new bathroom, the extension of a bedroom, the addition of a porch, and the construction of supporting walls. Id. The contractor subsequently completed the project, and plaintiffs continued to reside in the house through August 2002. Id. ¶¶ 1, 5. At that time, plaintiffs retained a second contractor to perform additional remodeling and renovation of their home. Id. ¶ 14. While performing roofing work related to the second remodeling project, a subcontractor discovered that the contractor that plaintiffs had hired in 1980 had left a gap between the stucco of the exterior walls and the flashing—i.e., the material used in wall and roof construction to prevent water penetration. Id. Over time, moisture had infiltrated the gap, causing extensive structural damage to plaintiffs' home. Id. ¶ 13.

After discovering the damage to their home, plaintiffs filed claims with both Safeco and Encompass. Both claims were denied, and plaintiffs commenced this action in San Francisco County Superior Court on July 31, 2003, alleging that each defendant breached its contract of insurance, acted in bad faith, and engaged in fraud. On October 10, 2003, defendants removed the action to this court. On February 19, 2004, Safeco filed a motion pursuant to Federal Rule of Civil Procedure 12(b)(6) to dismiss plaintiffs' complaint. Rather than opposing Safeco's motion, plaintiffs filed an amended complaint. On March 29, 2004, Encompass filed a motion requesting that the court strike plaintiffs' first amended complaint, or alternatively, enter judgment on the pleadings. On the same date, Safeco modified its motion to dismiss in light of plaintiffs' amended complaint. The court consolidated these motions for review, and on April 30, 2004, it issued an order denying Encompass' motion to strike, granting Encompass' motion for judgment on the pleadings, and granting Safeco's motions to dismiss. Order Granting Mot. to Dismiss First Amended Complaint ("FAC Order") at 7, 14. The court also granted plaintiffs leave to amend their pleadings. Id. at 14, 17 n.16.

On July 29, 2004, plaintiffs filed a second amended complaint, once again alleging causes of action for breach of contract, bad faith, and fraud against both defendants. As in the first amended complaint, plaintiffs allege that the 1980 contractor's negligently failed to close the gap between the

flashing and the stucco, resulting in extensive damage to their home. Id. ¶¶ 12-13, 16. To this, plaintiffs add the claim, allegedly based on newly discovered facts, that the lumber installed during the 1980 remodel was infested with "brown rot," a wood-destroying fungus that thrived in the moist conditions created by the contractor's negligent workmanship. Id. ¶ 8. Plaintiffs now assert that "[t]he efficient and predominant cause of the damage to [their] home . . . was the negligent failure of the supplier or suppliers of the wood to warn [plaintiffs] of the risk that brown rot existed in the wood and of the risk that, if the wood were exposed to water, the brown rot would grow and destroy the wood." Id. ¶ 11. Now before the court are defendants' motions to dismiss plaintiffs' second amended complaint under Federal Rule of Civil Procedure 12(b)(6). In the alternative, Encompass moves to strike plaintiffs' claims for fraud, bad faith and punitive damages. The court considers the issued raised by defendants' motions below.

LEGAL STANDARD

A motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) "tests the legal sufficiency of a claim." Navarro v. Block, 250 F.3d 729, 732 (9th Cir. 2001). "[U]nless it appears beyond doubt that plaintiff can prove no set of facts in support of her claim which would entitle her to relief," a motion to dismiss must be denied. Lewis v. Telephone Employees Credit Union, 87 F.3d 1537, 1545 (9th Cir. 1996) (citation omitted); see also Conley v. Gibson, 355 U.S. 41, 45–46 (1957). When assessing the legal sufficiency of a plaintiff's claims, the court must accept as true all material allegations of the complaint, and all reasonable inferences must be drawn in favor of the non-moving party. See, e.g., Cahill v. Liberty Mut. Ins. Co., 80 F.3d 336, 337–38 (9th Cir. 1996) (citations omitted). Dismissal is proper under Rule 12(b)(6) "only where there is no cognizable legal theory or an absence of sufficient facts alleged to support a cognizable legal theory." Navarro, 250 F.3d at 732 (quoting Balistreri v. Pacifica Police Dep't, 901 F.2d 696, 699 (9th Cir. 1988)).

DISCUSSION

I. Safeco's Motion to Dismiss

The court first addresses Safeco's motion to dismiss the third and fourth causes of action of plaintiffs' second amended complaint. As in the first amended complaint, plaintiffs allege that Safeco breached its contract of insurance with plaintiffs, as well as asserting claims of bad faith and fraud arising out of that breach. The parties agree that Safeco insured plaintiffs' home in August 2002, the date on which the damage to plaintiffs' home was discovered. See SAC ¶ 4 & Exh. 2. There is also no dispute that Safeco's policy is an "all risks, claims made policy"—i.e., a policy that covers all perils that are not expressly excluded. Id., Exh. 2. Safeco moves to dismiss based on several of these express exclusions. The first such exclusion upon which Safeco relies states in relevant part that the policy "do[es] not cover loss caused directly or indirectly by . . . faulty, inadequate, or defective . . . workmanship, repair, construction, renovation, [or] remodeling . . . [or by] materials used in repair, construction, renovation or remodeling." Id., Exh. 2 at 4 ¶ 14.

In its April 30, 2004 order, the court concluded that the plain meaning of this "faulty workmanship" exclusion compelled the dismissal of plaintiffs' claims against Safeco. The court observed that "[w]hat plaintiffs allege in their first amended complaint—namely, negligent construction resulting in a 'gap' between the 'flashing' and the stucco coating of their home—is exactly what Safeco's 'faulty workmanship' clause unambiguously covers." FAC Order at 11. In their second amended complaint, plaintiffs seek to avoid the unambiguous terms of this exclusion through a two-prong strategy. First, they plead newly discovered facts that would establish the presence of brown rot in the lumber as an actual and proximate cause of the damage to their home. SAC ¶ 8. Second, perhaps recognizing that the alleged defect in the lumber falls squarely within the "faulty materials" exclusion of Safeco's policy, see id., Exh. 2 at 4 ¶ 14, plaintiffs attempt to frame their claim as a cause of action arising out of an unnamed supplier's negligent failure to warn them of the defective condition of the lumber. Id. ¶ 11. Plaintiffs assert that because negligent failure to warn is not an excluded risk under Safeco's policy, neither the faulty workmanship nor faulty materials exclusion applies.

To assess whether plaintiffs' allegations fall within the scope of the defective workmanship and defective materials exclusions of Safeco's policy, the court must identify what is alleged to be the "efficient proximate cause" of plaintiffs' loss. The California Supreme Court first discussed this concept in Sabella v. Wisler, 59 Cal.2d 21 (1963), holding that:

> In determining whether a loss is within an exception in a policy, where there is a concurrence of different causes, the efficient cause—the one that sets the others in motion—is the cause to which the loss is to be attributed, though the other causes may follow it, and operate more immediately in producing the disaster.

Id. at 31 (alternations in original omitted). In Garvey v. State Farm Fire & Casualty Co., 48 Cal.3d 395 (1989), the court modified this formulation somewhat, holding that the efficient proximate cause is the "predominant" or the "most important" cause of the loss. Id. at 402, 406; see also Tento v. State Farm Fire & Cas. Co., 222 F.3d 660, 663 (9th Cir. 2000). However, what is relevant for the purpose of adjudicating the instant motion is not the verbal formulation employed by the California Supreme Court in defining efficient proximate cause, but rather the court's emphasis on the factual nature of this determination. For example, in Garvey, the court concluded that the trial court erred in directing a verdict on the question of efficient proximate cause, holding that "[c]overage should be determined by a jury under an efficient proximate cause analysis." Id. at 412; see also State Farm Fire & Cas. Co. v. Von Der Lieth, 54 Cal.3d 1123, 1131 (1991) (observing that "the question of what caused the loss is generally a question of fact").

As the court understands plaintiff's newly asserted failure to warn theory, the second amended complaint alleges that the efficient proximate cause of the damage to their home is the combination of the undisclosed existence of brown rot in the lumber used to remodel their home and the contractor's negligent workmanship, which allowed water to infiltrate the gap between the flashing and the stucco of the exterior allows. See SAC ¶¶ 9-13. Plaintiffs assert that the conditions under which brown rot flourished and destroyed their home would not have been present absent either one of these two negligent acts. See id. Consistent with the California Supreme Court's view in Garvey, the court accepts plaintiffs' allegations to be true for the purpose of adjudicating this motion. Thus, the court assumes without deciding that it is this synergistic relationship between the

existence of brown rot in the wood at the time of its installation and the exposure of the wood to water that is the "efficient and predominant cause" of the damage to plaintiffs' home. SAC ¶ 11.

Nonetheless, even if this synergistic relationship is the efficient proximate cause of plaintiffs' loss, Safeco's motion to dismiss must be granted if plaintiffs' allegations fall within the scope of the faulty workmanship or faulty materials exclusions of Safeco's policy. Although plaintiffs attempt to avoid these exclusions by alleging that the damage to their home was caused by an unnamed supplier's negligent failure to warn, neither common sense nor California law permits such artful pleading to override the unambiguous terms of an insurance policy. According to the California Supreme Court, a court must interpret insurance policy terms to give effect to the parties' intent and must construe policy limitations based on the "objectively reasonable" meaning that a layperson would ascribe to them. AIU Ins. Co. v. Superior Court, 51 Cal.3d 807, 822 (1990). Applying this principle, California courts have consistently concluded that a policyholder cannot avoid the objectively reasonable meaning of a policy limitation by changing the legal theory under which relief is sought. For example, in Century Transit Systems, Inc. v. American Empire Surplus Lines Insurance Co., 42 Cal. App. 4th 121 (1996), the court was called on to interpret a term in a cab company's insurance policy that denied coverage for "any claim based on assault and battery." Id. at 126 (original emphasis and alternations omitted). The court held that the exclusion "precludes coverage of any claim based on assault and battery irrespective of the legal theory asserted against the insured." Id. at 127 (original emphasis omitted). The court found it dispositive that "assault and battery [was] clearly the basis for the action," observing that "the fact that the claim also includes separate negligent acts by Century cannot avoid the exclusion." Id. at 128.

Similarly, in State Farm Fire & Casualty Co. v. Salas, 222 Cal. App. 3d 268 (1990), the court considered the relationship between a failure to warn claim and a closely related coverage limitation in an auto insurance policy. The case involved a claim for coverage arising out of an explosion that occurred while an auto mechanic was welding a tire rim of the policyholder's car. Id. at 271-72. In denying the policyholder's claim, State Farm relied on a policy limitation that excluded from coverage bodily injury and property damage claims "arising out of the . . . maintenance . . . of a

motor vehicle." Id. at 271. Seeking to avoid this exclusion, the policyholder argued that the mechanic's injuries were caused by the policyholder's own negligent failure to warn the mechanic that the tire had been injected with a flammable tire sealant four days prior to the explosion. Id. at 275. The court of appeal rejected this argument, reasoning that the policyholder's "failure to warn was inextricably bound up with his attempts to maintain his automobile's tire pressure." Id. at 276. Significantly, the Salas court also rejected the policyholder's attempt to conflate "legal causation concepts" with an interpretation of the applicable policy limits. Id. at 274 n.4. Instead, focusing on ordinary meaning of the policy limitations, the court held that "a layperson would find that the disputed policy provisions unambiguously exclude coverage," thereby compelling the court to reach the same conclusion. Id. at 274, 278.

The same reasoning applies to the instant case. As in Salas, the failure to warn that plaintiffs now allege to be the legal cause of the damage to their home is "inextricably bound up" with the remodeling and renovation carried out in 1981. Id. at 276. Construing the facts alleged in the light most favorable to plaintiffs, the second amended complaint establishes that the damage to plaintiffs' home was caused in part by an unnamed supplier's failure to take proper care in the treating or curing of the lumber used in the remodeling project. SAC ¶ 10. A layperson would conclude that such negligence falls squarely within a policy term that excludes coverage for damage caused by "defective materials" used in remodeling or renovation. Plaintiffs cannot overcome the plain meaning of this term by simply changing the label that they attach to the legal cause of the damage.

Plaintiffs cite Berry v. Commercial Union Insurance Co., 87 F.3d 387 (9th Cir. 1996), for the proposition that a failure to warn falls outside the defective workmanship and defective materials exclusions in Safeco's policy. However, the Ninth Circuit's reasoning in that case is entirely consistent with Salas and Century Transit. Berry involved a challenge to an insurer's denial of coverage for damage to aluminum irrigation piping caused by a copper hydroxide fungicide that the plaintiff had flushed through pipes. Id. at 388. While the insurer based its denial of coverage on the "defective maintenance" exclusion of its policy, the plaintiff argued that the damages were caused by the fungicide manufacturer's failure to warn consumers that its product was incompatible for use

with aluminum piping. Id. at 388, 392. The court rejected the insurer's argument, concluding that the fungicide manufacturers "were not 'maintaining property' and are therefore outside the scope of the exclusion." Id. at 392-93. Like Salas and Century Transit, the Berry court focused on the plain language of the policy to determine the scope of the exclusion. The court reasoned that "[e]ven if we assume that Berry was maintaining her property at the time she flushed the fungicides through the irrigation pipes, her act of maintenance was not a 'defective' one because the fungicide manufacturers had failed to warn her of the possible consequences of flushing copper hydroxide based chemicals through her pipes; she could not have been negligent in doing so." Id. at 392. In contrast, plaintiffs in the instant case allege that the damage to their home was caused by the combination of defective materials (the brown-rot infested lumber) and defective workmanship (the failure to close the gap between the flashing and stucco).[1] Both such defects are excluded perils under Safeco's policy. Plaintiffs' argument implies that a property loss caused by a combination of two excluded perils falls outside of both exclusions. California law does not permit such a tortured construction of the ordinary meaning of the policy language. Accord Tzung v. State Farm Fire & Cas. Co., 873 F.2d 1338, 1341 (9th Cir. 1989) (holding that "an unstrained interpretation of [a policy] exclusion for 'faulty workmanship' includes losses caused by defects in the design and construction of a building"). Thus, the court concludes that plaintiffs' alleged losses fall within the defective workmanship and defective materials exclusions of Safeco's policy.

When considering motions to dismiss for failure to state a claim, the court must accept the allegations in the complaint as true, drawing all reasonable inferences in favor of the non-moving party. Lewis, 87 F.3d at 1545. However, as this court observed in its order dismissing plaintiffs' first amended complaint, the liberal pleading standard set forth in the Federal Rule of Civil Procedure 8(a) does not "invite plaintiffs to use clever omissions and cynical pleading practices to overcome otherwise valid motions to dismiss." FAC Order at 10 (citing McHenry v. Renne, 84 F.3d 1172, 1177 (9th Cir. 1996)). In attempting to avoid the plain meaning of Safeco's policy by way of a sophistic failure to warn argument, plaintiffs' second amended complaint does exactly that. Although plaintiffs may have conducted extensive investigations to come up with detailed facts to

support their allegations, these facts are not a substitute for a well-grounded understanding of the legal basis for their claims. A claim of negligent failure to warn necessarily implicates a defective product or a product rendered defective. Such a claim falls squarely within the faulty materials exclusion of Safeco's policy. Indeed, since counsel acknowledged at oral argument that the lumber was supplied to the contractor and it was the contractor's use of the lumber that rendered it likely to be exposed to water, plaintiffs' theory also falls within the faulty workmanship exclusion.

Accordingly, the court holds as a matter of law that plaintiffs' claims fall within the faulty workmanship and faulty materials exclusions in Safeco's all risks policy. The court therefore grants Safeco's motion to dismiss.

II. Encompass' Motion to Dismiss

Having concluded that plaintiffs' claims against Safeco must be dismissed, the court now turns to Encompass' motion to dismiss the first and second causes of action of the second amended complaint, which allege breach of contract, bad faith, and fraud against Encompass. The court will first consider the scope of coverage under the policy issued by Encompass' predecessor-in-interest before turning to plaintiffs' equitable estoppel claim.

A. Coverage under Encompass' Policy

As noted above, Encompass' predecessor-in-interest issued an all risks insurance policy that covered plaintiffs' home during the period from July 1, 1979 to June 1, 1982. SAC ¶¶ 3, 14. It is undisputed that plaintiffs did not discover the damage to their home until August 2002, more than twenty years after plaintiffs terminated their coverage. Id. In its April 30, 2004 order, this court held that the fact that plaintiffs coverage had expired prior to the time that their loss was discovered was dispositive and that this fact warranted granting Encompass' motion for judgment on the pleadings. FAC Order at 7-10.

In so holding, the court relied on the "manifestation of loss" rule set forth in Prudential-LMI Commercial Insurance v. Superior Court, 51 Cal.3d 674 (1990), which states that liability for first party progressive property loss falls entirely on the insurer of the property at the time that the loss "manifests"—that is, at "the point in time when appreciable damage occurs and is or should be

known to the insured, such that a reasonable insured would be aware that his notification duty under the policy has been triggered." Id. at 699. Applying this rule to plaintiffs' allegations in the first amended complaint, the court concluded that damage to plaintiffs' home caused by the infiltration of moisture through the gap between the flashing and the exterior wall was progressive in nature and did not manifest until after plaintiffs' coverage with Encompass had terminated. FAC Order at 8-9. Accordingly, this court held Prudential's "manifestation rule" barred plaintiffs' claims against Encompass. Id. at 10.

Plaintiffs' second amended complaint once again concedes that their coverage with Encompass' predecessor-in-interest expired long before they could have reasonably discovered any evidence of damage to their home. SAC ¶ 15. This admission, together with the court's reasoning in its April 30 order, would appear to foreclose any good-faith basis under which plaintiffs could state a claim against Encompass. Nonetheless, plaintiffs seek to avoid the application of the manifestation rule though another variant of the "failure to warn" theory that they employ against Safeco. Specifically, plaintiffs argue that because the lumber supplier's negligent failure to warn them of the presence of brown rot in the wood used to construct their home occurred in 1980, the losses caused by the supplier's negligent conduct occurred within the policy period.

The court finds this argument to be without merit. First, it is manifestly clear that the allegation that brown rot fungus was present in 1980 does nothing to alter the "progressive" nature of plaintiffs' loss. Indeed, in Montrose Chemical Corp. v. Admiral Insurance Co., 10 Cal.4th 645 (1995), the court specifically identified "dry rot" as a "typical[]" kind of progressive or "progressively deteriorating" property damage. Id. at 658 n.6. Without deciding that "dry rot" and "brown rot" are the same thing, the fact that they are both gradual processes rather than sudden events is beyond doubt. Although plaintiffs do not seriously contest this point, they nonetheless attempt to characterize the gradual damage caused by brown rot as a one-time event caused by the wood supplier's alleged negligent failure to warn. In support of this view, plaintiffs rely heavily on language in Encompass' policy that provides coverage for "occurrences or losses during the policy period." SAC, Exh. 1 ¶ 6. Thus, according to plaintiffs, they had a reasonable expectation of

coverage for the loss caused by the supplier's negligent failure to warn, which allegedly occurred in 1980.

At the risk of repeating itself, the court points out that this argument was explicitly rejected in the court's April 30 order dismissing plaintiffs' first amended complaint. In declining to adopt plaintiffs' distinction between "occurrence" and "claims-made" policies for the purposes of applying Prudential's manifestation rule, the court held:

> [T]he relevant question is not whether Encompass' policy might be characterized as an 'occurrence policy' or a 'claims-made' one. Rather, the important question—as California's courts make plain—is whether the action involves a 'first party progressive party loss' instead of some form of 'third party' claim (e.g., a CGL policy). Neither Prudential nor any of its progeny suggest—let alone hold—that the 'manifestation rule' is inapplicable to a 'first party' claim simply because of some ambiguous policy language. Under Prudential, as long as the action concerns 'first party progressive property damage' the 'manifestation rule' controls.

FAC Order at 15 n.6 (citing Prudential, 51 Cal. 3d at 678-79); see also Prudential, 51 Cal.3d at 699 (observing that under the manifestation rule, "the insurer is not liable for a loss once its contract with the insured ends unless the manifestation of the loss *occurred* during its contract term") (emphasis added). In other words, first party progressive property loss is *deemed to occur* at the time that the loss manifests itself. See Prudential, 51 Cal.3d at 699. Plaintiffs cannot avoid the application of the manifestation rule by simply labeling their claim as one for negligent failure to warn.[2] Accordingly, the court holds that the manifestation rule excludes plaintiffs from coverage under Encompass' policy.

B. Equitable Estoppel

Arguing in the alternative, plaintiffs contend that even if the manifestation rule (or "progressive loss doctrine") applies, Encompass is estopped from denying coverage based on the rule

because Encompass did not identify the rule as a basis for rejecting plaintiffs' claim. Under California law, a party invoking equitable estoppel must prove each of the following elements:

> (1) the party to be estopped must be apprised of the facts; (2) he must intend that his conduct shall be acted upon, or must so act that the party asserting the estoppel had a right to believe it was so intended; (3) the other party must be ignorant of the true state of facts; and (4) he must rely upon the conduct to his injury.

Aloha Pac., Inc. v. California Ins. Guarantee Ass'n, 79 Cal. App. 4th 297, 314 n.15 (2000) (quoting California Ins. Guarantee Ass'n v. Workers' Comp. Appeals Bd., 10 Cal. App. 4th 988, 997 (1992)). In the context of insurance coverage, an insurer may be estopped from denying coverage if it fails to "fairly and accurately explain the covered risks" to the insured. Lawrence v. Western Mut. Ins. Co., 204 Cal. App. 3d 565, 574 (1988).

Applying this rule to the instant case, the court finds no basis for invoking the doctrine of equitable estoppel to bar Encompass from asserting a defense based on the manifestation rule. As noted above, plaintiffs must plead and prove that they are "ignorant of the true state of facts" to establish an equitable estoppel claim under California law. Aloha Pac., 79 Cal. App. 4th at 314 n.15. However, Encompass' response to plaintiffs' claims demonstrates that plaintiffs were fully informed of the reasons for Encompass' denial of coverage.[3] The first such response, dated October 2, 2002, clearly states: "Since you are [sic] not insured with us when you discovered the damage, there is no coverage under the policy as there is no present policy in force." SAC, Exh. 3. In response to a request to reconsider this decision, Encompass sent plaintiffs a second letter, dated July 14, 2003, informing them that "[w]hichever policy is in effect[] at the time of 'reasonable' discovery[] is the policy that will govern." Id., Exh. 4. These statements accurately, if somewhat tersely, describe the holding of Prudential as it applies to the instant case. In any event, the statements are far from being "so inaccurate and unfair as to amount to fraudulent concealment or misrepresentation sufficient to justify the application of the doctrine of estoppel." Lawrence, 204 Cal. App. 3d at 574.[4]

Plaintiffs have also failed to plead any set of facts on which they could prove that they relied upon Encompass' conduct to their injury. See Aloha Pac., 79 Cal. App. 4th at 314 n.15. The alleged nondisclosure on which plaintiffs claims to have relied occurred in 2002, more than twenty years after

their insurance coverage expired. Although plaintiffs now assert that they would have delayed demolition of their home to allow investigators to assess the extent of damage that occurred during the term of the Encompass policy, SAC ¶ 25, the court's discussion of the manifestation rule makes clear that this assessment would have no effect on the availability of coverage under the policy. Thus, plaintiffs' equitable estoppel claim is also foreclosed by the absence of detrimental reliance.

In summary, the court holds that the manifestation rule applies as a matter of law to bar plaintiffs' claims for coverage under Encompass' policy. Furthermore, for the reasons stated above, plaintiffs' second amended complaint fails to allege a legally sufficient basis for estopping Encompass from denying coverage. Accordingly, the court holds that plaintiffs have failed to state a claim on which relief may be granted and grant Encompass' motion to dismiss.

III. Leave to Amend

Having held that plaintiffs' second amended complaint must be dismissed in it entirety, the court must determine whether plaintiffs should be granted leave to amend. Under Federal Rule of Civil Procedure 15(a), a plaintiff may amend its complaint once as a matter of right prior to the filing of a responsive pleading. Fed. R. Civ. P. 15(a). Once the complaint has been answered or a responsive pleading has been filed, further amendments may be made "only by leave of court or by written consent of the adverse party." Id. Absent written consent of the adverse party, leave to amend lies "within the sound discretion of the trial court." DCD Programs, Ltd. v. Leighton, 833 F.2d 183, 185 (9th Cir.1987) (quoting United States v. Webb, 655 F.2d 977, 979 (9th Cir. 1981)). In exercising its discretion, a district court should consider the four factors identified by the Supreme Court in Foman v. Davis, 371 U.S. 178 (1962): (1) undue delay, (2) bad faith or dilatory motive, (3) futility of amendment, and (4) prejudice to the opposing party. Id. at182; see also Webb, 655 F.2d at 980. However, "[f]utility of amendment can, by itself, justify the denial of a motion for leave to amend." Bonin v. Calderon, 59 F.3d 815, 845 (9th Cir. 1995), cert. denied, 516 U.S. 1051 (1996). Furthermore, the Ninth Circuit has held that a district court has discretion to deny a motion for leave to amend "where the movant presents no new facts but only new theories and provides no

satisfactory explanation for his failure to fully develop his contentions originally." Id. (citing Allen v. City of Beverly Hills, 911 F.2d 367, 374 (9th Cir.1990)).

In this action, two factors support the court's denial of leave to amend: futility of amendment and the fact that plaintiffs previously amended the complaint. As to the first of these factors, the second amended complaint gives no indication that plaintiffs can allege any set of facts upon which relief may be granted. Indeed, in attempting to avoid the unambiguous limitations on their insurance coverage that led to dismissal of the first amended, plaintiffs rely almost entirely upon a novel and legally insufficient "failure to warn" theory. In light of this fact, allowing further amendment of plaintiffs' complaint would be futile. As to the second factor, plaintiffs have already amended their complaint twice without success. Although the court is mindful that leave to amend a complaint should be granted with "extreme liberality," Webb, 655 F.2d at 979, this policy in favor of liberal amendment of the pleadings has its limits. Thus, because plaintiffs have failed in three attempts to state a claim on which relief may be granted and the court has no reason to believe that a fourth attempt to do so would be successful, the court denies plaintiffs' leave to file a third amended complaint.

CONCLUSION

For the reasons stated above, the motions to dismiss of defendants Safeco and Encompass are GRANTED.[5] Plaintiffs' complaint is hereby DISMISSED WITH PREJUDICE.

IT IS SO ORDERED.

Dated: Oct 29, 2004

MARILYN HALL PATEL
District Judge
United States District Court
Northern District of California

ENDNOTES

1. Actually, plaintiffs attempt to side-step the faulty materials exclusion by claiming that the failure to warn goes not to the existence of brown rot in the lumber, but to the effect of exposure to water on lumber containing brown rot. Apparently, plaintiffs believe that this theory avoids the faulty materials exclusion. It does not. The claim involves a "material" rendered faulty by a failure to warn that it is likely to be dangerous for the use for which it is supplied.

2. Plaintiffs rely on Insurance Co. of North America v. Sam Harris Construction Co., 22 Cal.3d 409 (1978), for the proposition that Encompass is liable for third-party damage that occurred during the period of coverage. However, Sam Harris involved a third-party claims for negligent maintenance of an airplane rather than a first-party progressive property loss claim. Id. at 411-12. The Sam Harris case also predates the California' Supreme Court's decision in AIU Insurance Co. v. Superior Court, 51 Cal.3d 807 (1990)—decided in the same year as Prudential—which held that the interpretation of insurance policy contracts is subject to the same rules that apply to contracts in general. Id. at 821-23. The AIU court restricted the much more liberal rule of construction that had previously been in force, which not only required that any ambiguity in an insurer-drafted policy be construed in favor of the insured, but also allowed the insured to take advantage of this rule of construction so long as he or she could demonstrate that the proposed construction was "semantically permissible." See Mez Indus., Inc. v. Pacific Nat. Ins. Co., 76 Cal. App. 4th 856, 868 n.11 (1999) (calling into question numerous pre-AIU cases, including Sam Harris). Thus, to the extent that the manifestation rule announced in Prudential conflicts with Sam Harris and other pre-1990 California Supreme Court precedent, the court hold that the former controls the adjudication of the instant action.

3. Encompass' letters explaining its decision to deny coverage are attached as exhibits to plaintiffs' complaint. Thus, the letters are incorporated into the complaint and may be considered in determining the sufficiency of the pleadings pursuant to Federal Rule of Civil Procedure 12(b)(6). See United States v. Ritchie, 342 F.3d 903, 908 (9th Cir. 2003).

4. The court also rejects plaintiffs' assertion that the outcome of this action is governed by Spray, Gould & Bowers v. Associated International Insurance Co., 71 Cal. App. 4th 1260 (1999), and the California Insurance Commission Regulations interpreted therein, Cal. Code. Regs. tit. 10, § 2695.4(a). Spray, Gould held that an insurer could be estopped from raising a defense based on a one-year suit limitation in a policy if it had not complied with regulations requiring insurers to disclose all time limits that might apply to claims presented by the claimant. Id. at 1269; see also Neufeld v. Balboa, 84 Cal. App. 4th 759, 761 (2000). The court reasoned that the insurer could be estopped from raising the defense because the section 2695.4(a) of California Insurance Commission Regulations "imposes on insurers an unmistakable duty to advise its claimant insureds of applicable claim time limits." Spray, Gould, 71 Cal. App.4th at 1269. In contrast, in the instant case, Encompass denied plaintiffs' claims because their coverage had expired more than twenty years before the time that the claimed loss manifested itself. Thus, neither Spray, Gould nor section 2695.4(a) applies to Encompass' decision to deny coverage for plaintiffs' claims.

5. Because the court grants defendants' motions to dismiss for the reasons stated above, it need not address the other arguments raised in the parties' briefs.